

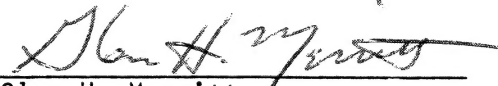
REPORT OF THE
OFFICE OF THE AUDITOR GENERAL
TO THE
JOINT LEGISLATIVE AUDIT COMMITTEE

216.3

STATE COLLECTION
OF PAYROLL TAXES AND RELATED
ADMINISTRATIVE PRACTICES OF THE
DEPARTMENT OF BENEFIT PAYMENTS (DBP)

NOVEMBER 1975

Respectfully submitted,


Glen H. Merritt
Chief Deputy Auditor General
November 12, 1975

Staff:

Richard I. LaRock
Thomas P. Friery
Ross Luna
Stephen Schutte



Joint Legislative Audit Committee

OFFICE OF THE AUDITOR GENERAL

California Legislature



CHAIRMAN
MIKE CULLEN
LONG BEACH

MIKE CULLEN
CHAIRMAN

VICE CHAIRMAN
CLARE BERRYHILL
CERES

ASSEMBLYMEN
EUGENE A. CHAPPIE
ROSEVILLE
JOHN FRANCIS FORAN
SAN FRANCISCO
BOB WILSON
LA MESA

SENATORS
ANTHONY BEILENSON
BEVERLY HILLS
GEORGE DEUKMEJIAN
LONG BEACH
JAMES R. MILLS
SAN DIEGO

November 26, 1975

The Honorable President pro Tempore of
the Senate
The Honorable Speaker of the Assembly
The Honorable Members of the Senate and the
Assembly of the Legislature of California

Members of the Legislature:

A sage once remarked, "The task of the Inspector General is much easier than that of getting the job done." Be that as it may, this report once again reflects a lack of diligence, indeed, a lack of interest on the part of public servants in saving taxpayers' money by innovative change.

Undisputably, California employers are able to deposit federal withholding taxes 12 to 52 days sooner than state withholding taxes, thus depriving the State of California from interest earnings of \$7 million annually. Presumably, the state's loss is the employers' gain.

The auditors are Richard I. LaRock, Supervisor; Thomas P. Friery, Ross Luna and Stephen Schutte.

Respectfully submitted,

MIKE CULLEN

TABLE OF CONTENTS

	<u>Page</u>
SUMMARY	i
INTRODUCTION	1
FINDINGS	3
WRITTEN RESPONSES TO THE AUDITOR GENERAL'S REPORT	
Director, Department of Benefit Payments	28
Director, Employment Development Department	29
State Treasurer	31
Director of Finance	32
APPENDIX A	
Auditor General's Estimate of Average Time Required For Mail Delivery to Sacramento from California Employers	33
APPENDIX B	
Auditor General's Preliminary Estimate of Additional Annual Bank Costs to Use a State Bank Collection Account for Payroll Taxes Collected by the Department of Benefit Payments	34

SUMMARY

This report is the third we have issued on the state's cash management and investment practices. It covers the collection of state payroll taxes and related administrative practices of the Department of Benefit Payments. We found a number of areas where changes in legislation or in policies and procedures would improve cash management and increase interest income to the state.

Findings

Page

State law allows large employers to retain California tax money withheld from employees' salaries for 12 to 52 days longer than they are permitted to retain similar federal taxes. Earlier remittance of payroll taxes withheld from employees by large employers would enable the state to invest these amounts earlier and increase state interest income.

3

Recommendation

7

California statutes permit the timely payment of payroll taxes through the U.S. mails, postmarked as late as the delinquent date. We estimate the total time elapsed before money remitted by employers can be invested by the state is approximately 4.05 calendar days. If the state required employers to remit state payroll taxes directly to a bank collection account, net interest income to the state should be increased.

8

Recommendation

14

	<u>Page</u>
Revenue received by the Department of Benefit Payments is initially distributed to various funds based on a formula. Adjustments are later made to correct the estimates, but no adjustment is made for loss of interest earnings while the money was misallocated. A revised allocation formula to offset previous misallocations would reduce the net loss of interest income to all funds combined resulting from the different rates of interest earned by each of the separate funds.	16
Recommendation	18
The Department of Benefit Payments is not enforcing legal requirements that employers remit payroll taxes monthly.	19
Recommendation	21
The time required to bill and collect voluntary plan disability insurance assessments is excessive and results in the loss of interest income to the state.	22
Recommendation	26

INTRODUCTION

In response to a legislative request, we have reviewed procedures of the State of California for the collection of payroll taxes and related administrative practices of the Department of Benefit Payments (DBP). This review is part of an overall review of the state's cash management and investment practices.

We have previously issued related reports on "Investment Policies of the Pooled Money Investment Board and Procedures of the State Treasurer" (No. 216, September 1974), and "Policies and Practices of the Employment Development Department for the Investment of the Cash Reserves of the State's Unemployment Compensation Disability Fund" (No. 216.2, March 1975).

The DBP was created by Chapter 1212, Statutes of 1973, and started operations July 1, 1974. The DBP consolidates the Health and Welfare Agency's fiscal control and manages the state's welfare payment program. In doing so the department specializes in collection, accounting and accounting systems, auditing claims payment, payment systems evaluation, and the welfare payment program.

The DBP is responsible for the collection of state personal income taxes withheld from employees' salaries, disability insurance contributions of employees and unemployment insurance contributions

of employers. These taxes and contributions are referred to in this report as state "payroll taxes".

For calendar year 1974, collections of payroll taxes by DBP amounted to approximately \$3 billion. In addition, DBP collects approximately \$6 million annually from insurance companies and other third parties which pay all or part of the medical bills of Medi-Cal recipients. These latter items were not included in our review.

FINDINGS

EARLIER REMITTANCE OF PAYROLL TAXES
WITHHELD FROM EMPLOYEES BY LARGE
EMPLOYERS WOULD INCREASE STATE
INTEREST INCOME.

State law allows large employers to retain California personal income taxes and disability insurance contributions withheld from employees' salaries for 12 to 52 days longer than they are permitted to retain similar federal income and social security taxes withheld. If California law required remittance of California taxes when similar payments are made to the federal government, additional net interest income estimated to be \$7 million annually could be earned by state funds; \$1 million by the Disability Fund, and \$6 million by the General Fund.

State and federal tax collection procedures require employers to remit payroll taxes withheld from employees' salaries periodically. The accumulated amount of money withheld determines the required frequency of remittance.

The state requires all employers to remit payroll taxes either monthly or quarterly. The dates these payments are to be remitted to the state coincide with the due dates for federal monthly and quarterly payments. Until the money is required to be paid to the state, employers may invest or use the funds as they wish.

Employers are required by statute to mail all quarterly payroll tax payments and returns to the state no later than the last day of the month following the end of the quarter (for example, October 31, for the quarter ending September 30). Those employers who are required to file monthly returns must mail tax payments and returns for the first two months of the quarter within 15 days following the end of the month (for example, August and September 15 for the months ending July and August 31, respectively). The third month's payment is due at the quarterly tax payment date which is the last day of the month following the end of the quarter.

In contrast to the state's monthly and quarterly payment schedules for all employers, the federal government requires large employers who have accumulated withholdings of federal income and social security taxes of \$2,000 or more to remit payments within three days after the end of quarter-monthly periods. Quarter-monthly periods end on the 7th, 15th, 22nd and last day of each month.

The amounts of accumulated federal and state payroll taxes withheld which require monthly and quarter-monthly remittance are shown below.

Accumulated Payroll Tax Withheld

	<u>Federal</u>	<u>State</u>	
<u>Remittance Periods</u>	<u>Income And Social Security Tax</u>	<u>Personal Income Tax</u>	<u>Disability Insurance Contributions</u>
Monthly	\$ 200	\$100	\$50
Quarter- Monthly	\$2,000	not required	not required

All employer unemployment taxes and other payroll taxes withheld for less than the above amounts are required by both the state and federal governments to be remitted quarterly.

If the state were to require quarter-monthly payments when proportionate amounts of withheld state payroll taxes under its jurisdiction are accumulated, employers withholding \$1,000 or more state personal income tax and \$500 or more state disability insurance contributions would be required to remit money withheld quarter-monthly. Employer unemployment taxes are collected by the state under federal jurisdiction.

Approximately 17,000 employers, or four percent of the 440,000 employers in the state, would be required to remit personal income taxes and disability insurance contributions withheld on a quarter-monthly basis. This would result in approximately 80 percent of the total annual state income tax and disability insurance contributions

withheld being remitted quarter-monthly rather than monthly. This money would be required to be remitted to the state 12 to 52 days sooner than presently required.

The earlier collection would permit earlier investment of these monies by the state. If the state could earn a six percent annual return on the earlier investments, this would increase gross interest income to the state by an estimated \$7.6 million annually. However, the DBP would have to process approximately 700,000 additional payments annually. We estimate the cost of additional processing to be \$600,000 annually, based on current unit costs of DBP. Thus, net additional interest income to the state from earlier collection and investment of amounts withheld by employers is estimated to be \$7 million annually.

In a report dated February 1973, a consultant recommended to the former Department of Human Resources Development, which was in charge of collecting state payroll taxes, that careful and thorough consideration be given to establishing significantly earlier due dates for payroll tax payments. Quarter-monthly payments were suggested as a possibility. DBP officials state that legislation was not pursued because the administration, at that time, did not want to put an additional burden on employers.

CONCLUSION

Earlier remittance of state payroll taxes withheld by employers would enable the state to invest these amounts earlier and increase state interest income.

RECOMMENDATION

We recommend that the Senate and Assembly Committees on Revenue and Taxation consider legislation to require quarter-monthly remittance of state personal income taxes and disability insurance contributions withheld from employees' salaries by large employers, similar to federal requirements for remitting federal taxes withheld.

BENEFITS AND SAVINGS

Legislative implementation of this recommendation will increase net interest income to the state by an estimated \$7 million annually, could prevent the need to increase taxes in the future, and would make state requirements for remitting payroll taxes withheld by employers similar to federal requirements.

USE OF A BANK COLLECTION ACCOUNT FOR
THE COLLECTION OF STATE PAYROLL TAXES
SHOULD INCREASE STATE INTEREST INCOME.

If the state required employers to remit state payroll taxes directly to a bank collection account, similar to that used by the federal government, net interest income to the state on DBP deposits would be increased an estimated \$750,000 annually.

The federal government requires that most federal payroll taxes be deposited directly into banks by employers no later than the due date. Approximately 80 percent of revenue collectable through the federal tax deposit system is collected by banks. For deposits of small amounts, the employers may mail tax payments directly to the federal government. However, the employers must be able to provide proof that such payments were placed in the mail two days before the delinquent date.

In contrast to the federal requirements, California statutes permit the timely payment of payroll taxes through the U. S. mails, postmarked as late as the delinquent date. The state does not have a bank collection system which would eliminate mail delivery time and time required to make deposits.

During our review, we made tests to determine mail delivery time for various periods from February to August 1975. Based on postmarks, we found that the mail delivery time ranged from 1.55 to 1.78 business days and averaged 1.64 business days. These tests

reaffirmed the results of a study made previously for the Department of Human Resources Development by a consultant. In its report of February 1973, the consultant stated the average mail delivery time was 1.6 business days.

The consultant also reported that eight percent of the mail placed in sidewalk boxes before 5:00 p.m., and 81 percent of the mail placed in sidewalk boxes after 5:00 p.m., received the next day's or a following days postmark. Further, large employers are likely to mail late in the day so as not to jeopardize employers' interest accruals for the day. Six-tenths of one percent of employers reporting monthly contribute nearly 55 percent of the dollars received. Therefore, we adjusted the average mail delivery time of 1.6 business days, based on postmarks, to compensate for mailing practices and practices of the post office in affixing postmarks.

Based on our review and the consultant's study, we estimate that on average approximately 2.92 calendar days are required for mail delivery. Our calculation is shown in Appendix A. We found that an additional .64 calendar day is required for processing by the DBP before the receipts are deposited, and .49 day for bank collection of DBP deposits. Therefore, we estimate the total time elapsed before money remitted by employers can be invested to earn interest for the state is approximately 4.05 calendar days.

If the DBP collections of more than \$3 billion annually were invested at six percent 4.05 days earlier, gross additional interest income of approximately \$2 million would be earned by the state and certain trust funds annually.

The State of California cannot begin using a bank collection account immediately, however, because the state is under contract with the Security Pacific National Bank through June 30, 1977. This contract was awarded under competitive bid procedures and was based on projected amounts of deposits, including payroll taxes presently collected by DBP. It provides that the specified state deposits of collections by DBP and three other state agencies be made with the Security Pacific National Bank. In addition, officials of major California banks told us that the development of a state bank collection account system would take the cooperation of the entire banking community and would require at least one year to develop.

Certain bank costs, in addition to those presently incurred by the state, would be encountered if a state bank collection account were used and would reduce additional interest income received because of earlier deposits. These costs cannot be precisely determined until criteria for a state bank collection system have been designed by appropriate state officials, and until authorizing legislation has been developed.

Appropriate state officials should include officials of the DBP as well as of the State Treasurer's Office and the Department

of Finance. The State Treasurer and the Director of Finance, both individually and as members of the Pooled Money Investment Board, have responsibility to designate banking guidelines and to provide a state banking system for the deposit of state receipts.

The State Treasurer's Office advised us that they would favor a bank collection account if further study indicated net additional interest earnings to the state. However, the State Treasurer's Office is opposed to a bank collection account if used only for remittance of state payroll taxes. The State Treasurer's Office opinion is that better terms may be obtained from banks if the account were also used by other state revenue collection agencies, such as the Board of Equalization.

The federal government uses its tax collection account to collect:

- Withheld income and FICA taxes
- Corporate income taxes
- Excise taxes
- Federal unemployment taxes
- FICA taxes for agricultural workers.

Our preliminary estimate indicates that the costs of operating a bank collection account for the collection of state payroll taxes alone would be approximately \$1.25 million annually. Details

of this estimate are shown in Appendix B. We estimate that the use of a bank deposit system by DBP, rather than the present system, would result in increased net interest income to the state of \$750,000 annually. Of this amount, approximately \$450,000 would be earned by the state's General Fund, \$195,000 would be earned by the Unemployment Fund, and \$105,000 would be earned by the Disability Fund.

As shown in Appendix B, our preliminary estimates of additional bank charges were based on average bank cost estimates presented to the Department of Human Resources Development by two major California banks in 1972. The cost estimates were requested as part of the department's study of various deposit systems which might be used for collection of payroll taxes. These costs were increased by an eight percent annual inflation factor which approximates the average annual rate of inflation since 1972. From these costs we deducted present bank charges of approximately \$21,000 annually incurred by the State Treasurer relating to DBP collections.

Errors and omissions in the department's analysis of the proposals resulted in the conclusion that a bank collection account would be more costly than the current or alternative collection systems. For example:

- The department's analysis assumed that all cash receipts received by the department would be deposited the same day. We found that it takes DBP an average of .64 calendar day to process collections before they are deposited

- The department's analysis omitted calculations of mail delivery time. We estimated the mail delivery time to be 2.92 calendar days based in part on a study of a consultant later hired by the department.

In July 1972, EDD declined the bank's proposals. EDD stated that the proposals did not include sufficient consideration of operating data required by the department for accountability, and expressed concern that the proposal was more costly than the state's present collection system.

In February 1973, a consultant was retained to prepare a study on mail delivery time for EDD. The consultant recommended that EDD consider the feasibility of establishing a depository receipt bank collection account similar to that of the federal government's tax collection system. No action was taken by EDD.

In July 1974, the DBP started operations. As of June 1975, the DBP officials had not begun study of the feasibility of using a state bank collection system. Since then, Department of Finance personnel have expressed some interest in a bank collection system in connection with a study to consider establishment of a state bank.

In summary, California statutes do not provide for remittance of state payroll taxes by employers directly to a bank collection

account similar to the federal government's bank deposit system. Enabling legislation to authorize a bank collection system for the state has not been pursued by EDD or DBP. Criteria for the state bank collection system included in the 1972 study were not properly established, and errors and omissions were made in the analysis of the costs of a bank collection system.

CONCLUSION

The state's present system for collecting payroll taxes results in less interest income to the state than should be possible under a system similar to that used by the federal government for collection of such taxes.

RECOMMENDATION

We recommend that legislation be enacted authorizing the use of a bank collection system for collection of state revenues. Further, we recommend that the Department of Benefit Payments, in conjunction with other major revenue agencies, the State Treasurer and Department of Finance, (1) develop criteria for a state bank collection system to be used by major revenue agencies, and (2) conduct negotiations with banks to determine the economic feasibility of such a system to be implemented by July 1, 1977.

SAVINGS

Implementation of a bank collection system by the state should result in additional interest income to the state on deposits of state payroll taxes estimated to be \$750,000 annually beginning in 1977.

INTRA-FUND ADJUSTMENTS FOR ALLOCATION
OF PAYROLL TAXES ARE INEQUITABLE

After revenue is received by the DBP it is initially distributed in estimated amounts to the Personal Income Tax Fund, a feeder fund to the General Fund, Unemployment Fund, Disability Fund, and other funds based on a formula. Later, adjustments are made to correct the estimates. However, the adjustments do not consider the length of time monies are misallocated.

During the 29 months ended May 31, 1975, it took an average of 48 to 81 days for the DBP to determine the actual amount of income due each fund for each day's deposits, and to implement the adjustments for various funds. No adjustment was made for loss of interest earnings to funds while the money was misallocated.

Such delay results in inequitable interest earnings among the funds and, because of lower earnings rates of the Unemployment Fund and the Disability Fund (which consistently were initially allocated too large a share of DBP receipts), it also results in a net loss of interest earnings to all state funds. For the 29 months ended May 31, 1975, we estimate the loss to be \$666,000, as shown on the following page.

<u>Fund</u>	<u>Amount Misallocated Over (Under)</u>	<u>Average Number Of Days Misallocated</u>	<u>Weighted Average Annual Earnings Rate Of Fund</u>	<u>Gain or (Loss) Of Investment Earnings For 29 Months</u>
Personal Income Tax Fund	(\$131,493,000)	75 days	8.32% ^{1/}	(\$2,248,000)
Employment Development Contingent Fund	(4,087,000)	48 days	8.30% ^{1/}	(45,000)
Unemployment Fund	57,720,000	81 days	5.79%	742,000
Disability Fund	78,390,000	69 days	5.97%	885,000
Other	<u>(530,000)</u>	n/a	n/a	<u>n/a</u>
All State Funds	<u>\$ 0</u>	n/a	n/a	<u>(\$ 666,000)</u>

^{1/} Invested as part of the Pooled Money Investment Account

Department officials state that to make a precise adjustment based upon the amount misallocated and the number of days it was misallocated would be exceedingly complicated and would require additional staff. We concur.

However, we believe the inequitable distribution and loss of interest income can be mitigated by altering the allocation formula presently used by the department to adjust for prior misallocations.

RECOMMENDATION

We recommend that the Department of Benefit Payments adjust for the length of time money is misallocated among funds by revising its deposit allocation formula to offset previous misallocations.

BENEFITS

Implementation of this recommendation will mitigate improper allocation of interest income to various state funds, and will reduce the net loss of interest income to all funds combined resulting from the different rates of interest earned by each of the separate funds.

REQUIREMENT THAT EMPLOYERS REMIT
TAXES MONTHLY IS NOT ENFORCED.

The Department of Benefit Payments is not enforcing provisions of law which require monthly remittance of personal income tax and disability insurance contributions withheld from employees' salaries. According to DBP records, approximately 12,700 employers required to remit withholdings monthly, (based on the amount of their quarterly returns) remit quarterly instead. The DBP assesses no penalty or interest charges for these late remittances. Department officials state that the assessment of penalties and interest was stopped because of lack of personnel. Other departmental functions were given higher priority.

Net penalties and interest income assessed the first time on the late remittances would be approximately \$179,000. Subsequently, the department would receive net penalty and interest income of an undetermined amount. If all employers who have previously filed with the department and receive reporting forms monthly were to remit payments monthly as required, additional interest income would amount to an estimated \$123,000 annually.

Approximately 6,000 employers are on DBP mailing lists and receive reporting forms monthly. The remaining 6,700 employers are not on DBP mailing lists. The 6,000 noncomplying employers on the DBP's mailing list remit approximately \$18.7 million annually. If these 6,000 employers remitted monthly as required by law, and these monies

were invested at a six percent annual investment rate, approximately \$123,000 additional interest income would be earned annually.

All employers who do not comply with payment provisions may be assessed a 10 percent penalty and must be assessed interest at the rate of 1/2 of 1 percent per month. However, penalty and interest is not billed unless it exceeds \$5.00. In addition, DBP cancels approximately 36 percent of the penalty and interest billings it does make because they were either erroneous or because the payments were delinquent for good cause.

Taking these factors into consideration, and assuming that no penalties would be assessed against those employers not on the department's monthly mailing list in accordance with DBP guidelines, we estimate that one-time enforcement would produce penalties and interest of \$229,000. Enforcement consisting of follow-up letters and penalty and interest billings for delinquent employers would cost approximately \$50,000. Thus, net penalty and interest income of \$179,000 would be produced.

CONCLUSION

The department is not enforcing legal requirements that employers remit payroll taxes monthly. Enforcement of the requirements would result in equal treatment of all taxpayers and additional net income

to the state from penalties and interest on late filings plus interest income from investment of the additional revenues.

RECOMMENDATION

We recommend that the Department of Benefit Payments assess penalty and interest, as provided by law, on employers identified by the department as not complying with the monthly remittance requirements.

BENEFIT

First-time enforcement of the monthly remittance requirement will result in net penalty and interest income of approximately \$179,000. Subsequently, the department will receive net penalty and interest income of an undetermined amount or, if all employers who have previously filed with the department remit payments monthly as required, the department will earn additional interest income estimated to be \$123,000 annually.

AMOUNT OF TIME TAKEN TO COLLECT
VOLUNTARY PLAN ASSESSMENTS IS
EXCESSIVE.

As an alternative to the State Disability Insurance Program, California employers may provide separate disability insurance programs for their employees called voluntary plans, if certain requirements are met. However, the Department of Benefit Payments has the responsibility to assess and collect from voluntary plan employers those costs initially borne by the State Disability Insurance Program, such as disability benefits paid to unemployed workers.

The methods used for calculating and billing voluntary plan assessments to reimburse the Disability Fund delay reimbursement to the state by an average of six months. When compared to receipts from employers insured as part of the State Disability Insurance Program, and who determine their own liability and remit monies either monthly or quarterly, this delay is excessive.

Approximately \$4.5 million is billed annually. Calculated at six percent, the delay in billing results in lost interest earnings to the Disability Fund of approximately \$140,000 annually. Additional interest income of approximately \$11,000 per year could be earned if all assessments were billed quarterly. Current methods of calculating and collecting the assessments cost approximately \$10,000 per year more than a self-assessing procedure.

The three assessments are made at different times of the year and each has different methods of calculation. The assessments and the time required to bill each assessment are described below.

Unemployed Disabled Assessment

The Unemployed Disabled Assessment is levied against voluntary plan employers by the DBP to recover the voluntary plan employers' share of unemployed disability benefits paid initially by the Disability Fund, as provided by law. This assessment amounts to approximately \$4 million annually.

The Unemployed Disabled Assessment is made quarterly, based upon a fixed assessment rate of .0012 of taxable wages as provided by statute. During the three years ended June 30, 1974 this assessment was not billed until an average of 177 days following the end of each calendar quarter. Calculated at six percent, this delay in billing results in the loss of interest earnings to the Disability Fund of approximately \$116,000 annually.

Department officials attribute a large part of the delay to difficulty with wage adjustments and delays by the Employment Development Department data processing.

Administrative Cost Assessments

Administrative cost assessments amounting to approximately \$312,000 annually are levied against voluntary plan employers to recover actual administrative costs incurred by the state related to voluntary plans. During the three years ended June 30, 1974 the administrative cost assessments were not billed until an average of 206 days after the end of the fiscal year for billing. Calculated at six percent, this delay in billing results in the loss of interest earnings to the Disability Fund of approximately \$10,000 annually.

Department officials attribute these delays to the time required to determine the amount of administrative costs chargeable to voluntary plans.

Worker Refund Assessments

Worker refund assessments amounting to approximately \$174,000 annually are levied against voluntary plan employers to recover the voluntary plan employers' share of refunds paid from the Disability Fund. The refunds are paid to employees who had more than the maximum amount of disability insurance contributions withheld from their salaries during the year. Generally, such employees worked for more than one employer during the year.

For the three years ended December 31, 1970 through 1972, these assessments were not billed until an average of 498 days after the end of the assessment year. Calculated at six percent, this delay in billing results in the loss of interest earnings to the Disability Fund of approximately \$14,000 annually. The assessment for the year ended December 31, 1972 was billed on February 4, 1975, or 765 days after the end of the period.

Department officials attribute these delays to problems with the assessment information provided by the Employment Development Department data processing, and problems in conversion to a new system involving the Franchise Tax Board.

The actuarial report for the Disability Fund for 1971 stated that the methods of calculating the administrative cost assessment and the worker refund assessment were relatively complex and expensive. The report suggested that if any changes were to be made in the assessments, all three assessments should be combined into one. The actuarial report states:

"...In view of the necessarily arbitrary amount of the much larger assessment for unemployed disabled, it seems illogical to require the Department to spend the required time for the smaller assessments. The present system is no problem because of the small size of the voluntary plan proportion, but if any changes were to be made in the assessments our recommendation would be to recognize the arbitrary aspects and assess as politically and practically expedient, a total flat rate of 0.14% of gross taxable wages, which is about the current average total level..."

Additional interest income of approximately \$11,000 annually could be earned if all three assessments were billed quarterly, as is presently done for the Unemployed Disabled Assessment. A savings of an estimated one man-year, or approximately \$10,000, could be realized from work simplification if the three assessments were combined into a single fixed rate and made self-assessing.

Previous recommendations to make voluntary plan assessments self-assessing were resisted by the former State Department of Human Resources Development because of potential administrative problems. Also, there was question as to the ability and willingness of the employers to speed up their payment of the assessments. However, personnel within the Department of Benefit Payments presently indicate that a self-assessing procedure would be administratively practical without increasing overall workload or costs. Also, they stated that a self-assessing procedure would not be impractical for the employers.

CONCLUSION

The time required to bill and collect voluntary plan disability insurance assessments is excessive and results in the loss of interest income to the state.

RECOMMENDATION

We recommend that the Senate Insurance and Financial Institution Committee and the Assembly Committee on Finance, Insurance and Commerce consider legislation

to combine the three disability insurance voluntary plan assessments into a single fixed rate assessment and that such payment be made self-assessing and payable with quarterly tax returns.

BENEFITS

Legislative implementation of this recommendation would increase interest income to the Disability Fund by approximately \$151,000 annually, and simplify current assessment procedures resulting in a savings of approximately \$10,000 annually.

DEPARTMENT OF BENEFIT PAYMENTS

744 P Street, Sacramento, CA 95814
(916) 322-3210



November 13, 1975

Mr. Glen H. Merritt, Chief
Office of the Auditor General
925 L Street
Sacramento, CA 95814

Dear Mr. Merritt:

This is in response to the draft of your report on the review you recently completed on some of the operations of this Department. Our reaction to each of the five recommendations contained in your report follows:

1. We will suggest for Agency consideration legislation requiring earlier remittances of contributions and taxes from large employers.
2. The recommendation that the Department of Benefit Payments seek legislation authorizing the use of a State Bank Collection System is not appropriately made to this Department. The recommendation should more appropriately be made to the State Treasurer and the Department of Finance to conduct a study regarding the feasibility of such a collection system. We will cooperate and assist in the conduct of such a study.
3. We agree that an adjustment should be made to compensate for misallocations of funds brought about by the use of the formula, and we would appreciate the opportunity of discussing with you the methodology by which this should be accomplished.
4. The assessment of penalty and interest on late monthly payments has been given a lower priority in order to use all available resources to work on the more immediate problem of converting the employer accounting system to data processing. We intend to follow this recommendation as soon as additional employees and the space to house them can be acquired.
5. We will conduct a study in conjunction with Employment Development Department to determine the feasibility of combining the voluntary plan assessments.

Sincerely,

MARION J. WOODS
Director

Memorandum

To : Mr. Glen H. Merritt
Chief Deputy Auditor General
925 L Street, Suite 750
Sacramento, CA 95814

Date : November 10, 1975

File No.:

From : **Employment Development Department**

Subject: COMMENTS - AUDITOR GENERAL'S REPORT ON STATE COLLECTION OF PAYROLL TAXES

The following are our comments concerning those sections of your Report No. 216.3 on Collection of Payroll Taxes which involve Employment Development Department.

REPORT ITEM: INTRA-FUND ADJUSTMENTS FOR ALLOCATION OF COLLECTION OF PAYROLL TAXES ARE INEQUITABLE. Page 16

AUDITORS' RECOMMENDATION: "We recommend that the Department of Benefit Payments adjust for the length of time money is misallocated among funds by revising its deposit allocation formula to offset previous misallocations."

COMMENTS: We concur in principle that an adjustment should be made which would enable the restoration of interest loss due to prior misallocations. We are agreeable to implementing this recommendation with respect to misallocations occurring on and after July 1, 1975 under the following condition:

A legal opinion should be obtained to determine if this action will result in a violation of federal law involving the Unemployment Trust Fund collections or any Special Fund collections.

It is our recommendation that a joint study be conducted by EDD and DBP in an attempt to improve the present formula methods.

REPORT ITEM: AMOUNT OF TIME TAKEN TO COLLECT VOLUNTARY PLAN ASSESSMENTS IS EXCESSIVE. Page 22

AUDITORS' RECOMMENDATION: "We recommend that legislation be enacted to combine the three disability insurance voluntary plan assessments into a single fixed rate assessment and that such payment be made self-assessing and payable with quarterly tax returns."

COMMENTS: We concur with this recommendation. The combined assessment may impose additional work on employers and will require the payment of a greater amount of tax during the first year of implementation to catch up on prior quarter assessments.

Mr. Glen H. Merritt

-2-

Contained in this same item was the statement that administrative costs attributable to voluntary plans were not billed until an average of 206 days after the end of the fiscal year. This was true during the period studied but now with more timely cost accounting reports these costs can now be billed within 105 days following the close of the fiscal year.

Also contained in this item was the statement that a large part of the delay in billing Unemployed Disabled Assessment (UDA) was caused by delays in EDD Data Processing. This was true for prior tax years because of heavy workload and other priorities. However, for the last two quarters our record for processing UDA has been two weeks late for the October-December 1974 quarter and on schedule for the January-March 1975 quarter.

A Merit Award Board suggestion is now being reviewed by DBP that recommends manually processing UDA (350 accounts). Preliminary review indicates that if this small job was done manually the bulk of the assessments could be mailed by DBP within 45 days after the end of the calendar quarter.

Mart R. Glick

MARTIN R. GLICK
Director

Memorandum

To : Office of the Auditor General
925 L Street, Suite 750
Sacramento, CA 95814

Date : November 10, 1975

File i

From : State Treasurer's Office

Subject: State Collection of Payroll Taxes
and Related Administrative Practices
of the Department of Benefit Payments

We have reviewed your November 1975, draft report which recommends that the Department of Benefit Payments seek enabling legislation to authorize a bank collection system for the cashing of payroll taxes.

As you are aware, in February of this year we requested the Accounting Systems Section of the Department of Finance to study the feasibility of collecting selected State taxes through use of local banks. At that time we believed that a bank collection system had benefit potential and your findings seem to support this theory at least in regard to the one agency.

While we find no particular disagreement with the conclusions contained in your draft, we continue to believe that any successful bank collection system should provide for the handling of more than one type of tax. Consequently, we believe it inappropriate to comment further until completion of the Department of Finance study.



Charles C. Haskins
Chief Deputy State
Treasurer 916/445-6561

Memorandum

Date : November 5, 1975

To : Mr. Richard I. LaRock
Audit Manager
Office of the Auditor General
925 L Street, Suite 750


From : Department of Finance
Accounting Systems

Subject: Proposed State Payroll Tax Collection Procedures

You have asked that we review and comment on that portion of Audit Report 216.3 pertaining to a recommendation for "Use of a Bank Collection Account for the Collection of State Payroll Taxes" at the Department of Benefit Payments.

Generally, we are in agreement with the need for a comprehensive study of the economic feasibility of a bank collection account system as described in the report. At the same time, we feel that alternative methods for improving the existing cash gathering systems should be analyzed so that any potential increases in interest earnings can be realized at the lowest cost.

Our staff is presently analyzing the feasibility of an alternative cash gathering system and upon completion of this study, we are planning to analyze the bank collection account system. However, our current efforts may be delayed due to priority assignments and availability of staff.


W. S. Bierly
Chief, Accounting Systems

AUDITOR GENERAL'S ESTIMATE OF AVERAGE
TIME REQUIRED FOR MAIL DELIVERY TO SACRAMENTO
FROM CALIFORNIA EMPLOYERS

Average time required for mail delivery based on postmarks	1.6 business days
Estimate of percentage of total dollar volume of returns mailed by employers late in the day so as not to jeopardize employers' interest accruals for the day ^{A/}	55%
Estimated percent of returns mailed late in the day which receive the next day's or following day's postmark ^{A/}	89%
Adjustment to reflect that an estimated 55 percent of the dollar volume of remittances received the next day's postmark 89 percent of the time (.55 x .89 days)	<u>.489</u> business days
Total business days	2.089 business days
Total calendar days (2.089 business days x 1.4 ^{B/})	<u><u>2.920</u></u> calendar days

^{A/} These estimates are based on our analysis of data contained in a consultant's report received by the Department of Human Resources Development in 1973.

^{B/} Conversion factor to convert business days to calendar days.

APPENDIX B

AUDITOR GENERAL'S PRELIMINARY ESTIMATE OF ADDITIONAL BANK COSTS
TO USE A STATE BANK COLLECTION ACCOUNT FOR
PAYROLL TAXES COLLECTED BY DEPARTMENT OF BENEFIT PAYMENTS

	Number of Checks (a)	Amount of Deposits (b)	Bank Collection Time (Calendar Days) (c)	Weighted Collection Time (bxc) (d)	Bank Costs (e)
Bank Collection Costs					
Estimated 1975-76 collections	2,800,000	<u>\$3,000,000,000</u>			
Checks drawn and deposited in same California bank		2,022,150,000	-0-		
Checks drawn on California bank and deposited in another bank ^{A/}		356,850,000	1.4 days	\$ 499,590,000	
Checks drawn on out-of-state banks		<u>621,000,000</u>	2.8 days	<u>1,738,800,000</u>	
Totals		<u>\$3,000,000,000</u>		<u>\$2,238,390,000</u>	
Total weighted collection time + total deposits (\$2,238,390,000 ÷ \$3,000,000,000)				.74613 days	
Estimated value of time required to make bank collections (\$3,000,000,000 x .74613 days x 6% per year interest income)					\$ 367,954.52
Bank Service Charges (.3214 ^{B/} x 2,800,000 checks)					<u>899,920.00</u>
Subtotal					1,267,874.52
Less: Present bank costs incurred by the State Treasurer on DBP collection operations					<u>21,000.00</u>
Estimated annual costs of a bank collection account for collection of payroll taxes					<u>\$1,246,874.52</u>

^{A/} The assumption is made that the state will have demand accounts with nine banks as it does at present.

^{B/} Average of bank service charges presented to Department of Human Resources Development by two major California banks in 1972, increased by annual inflation factor of eight percent a year for three years.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps